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An Analysis on the Current Situation, Risks and Countermeasures of China's International Capital Flows

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***Abstract*—International capital flows become an important factor affecting a country's financial risk. In China's capital account, direct capital investment is basically liberalized, while financial investment is partially liberalized. Since the financial crisis, China's capital flows have assumed new characteristics. With a large amount of capital flows, China is the largest investment recipient and outward investor among developing countries. Capital inflows and outflows fluctuated fiercely. The rapid growth in overseas investment and foreign capital inflows will increase the potential risks of China's financial system. The two most common risks that trigger China's financial risks are imported risks and endogenous risks. In order to cope with the financial risks, China should strengthen the supervision of international capital flows and capital markets, and rationally screen and utilize foreign capital.**

Keywords*—capital flows, capital account, financial risk, capital market

I. Introduction

International capital flows are the transfer of capital from one country or region to another, that is, the transfer of capital between countries. In the light of the flow direction, capital flows can be divided into inflows and outflows. In accordance with the report submitted by the Bank for International Settlements in 2016, international capital flows are playing an increasingly significant role in financial market cycles of emerging economies and will reinforce the extent of the financial booms (and recessions) in these countries. At the same time, on October 1, 2016, China officially joined the Special Drawing Rights (SDR) money basket of International Monetary Fund (IMF), and piloted RMB capital account convertibility in the Shanghai Free Trade Zone to improve the internationalization of RMB. All of these mean that there may be new changes in international capital flows.

II. The Degree of Openness of China's Capital Account

According to the *Annual Report on Exchange Arrangements and Exchange Restrictions* of the International Monetary Fund in 2011, there are 4 non-convertible accounts in China, accounting for 10%, and they are mainly involved in the domestic monetary market, fund trust market and traded derivatives. There are 22 partial convertible accounts, accounting for 55%, and they mainly concentrated in bond market transactions, stock market transactions, real estate transactions and personal capital transactions. In addition, there are 14 basic convertible accounts, mainly focusing on credit instrument transactions, direct investment, direct investment liquidation, and so on.

TABLE I. THE DEGREE OF OPENNESS OF CHINA'S CAPITAL ACCOUNT

Relevant transactions of convertibility status	Non- convertibility	Partial convertibility	Basic convertibility	Full convertibility	Total
Capital and monetary market instrument trading	2	10	4		16
Derivatives and other instruments trading	2	2			4
Credit instrument transactions		1	5		6
Direct investment		1	1		2
Direct investment liquidation			1		1
Real estate transactions		2	1		3
Personal capital transactions		6	2		8
Subtotal	4	22	14		40

Note: The status of convertibility includes non-convertibility, partial convertibility, basic convertibility and full convertibility. Among them, partial convertibility has strict access restrictions or quota controls. Meanwhile, what basic convertibility means is that there are some restrictions, but the restrictions are relatively loose and exchange can be completed after registration or approval [1].

The opening of capital account does not mean that there is no control at all. Compared with the specific classification in capital account of China, the United States and Japan in 2012, it can be seen that China has some controls of capital account similar to that of the United States and Japan. At the same time, there is no controlling account for commercial credit. There is no control in the United States and Japan, and there are only five controlling accounts in China. Financial credit projects are not controlled in the United States, but controlled in China and Japan. Commitments, guarantees and financial support facilities are not controlled in Japan, but controlled in China and the United States. Direct investment liquidation, personal capital transactions and commercial banks and other credit institutions are not controlled in the United States and Japan, but controlled in China.

TABLE II. THE SPECIFIC CLASSIFICATION IN CAPITAL ACCOUNT OF CHINA, THE UNITED STATES AND JAPAN IN 2012

Country	China	the United States	Japan
Capital market securities			
Monetary market instruments			
Collective investment securities			
Derivatives and other instruments			
Commercial credit	√	√	√
Financial credit		√	
Commitments, guarantees and financial support facilities			√
Direct investment			
Direct investment liquidation		√	√
Real estate transactions			
Personal capital transactions		√	√
Commercial bank and other credit institutions		√	√
Institutional investors			

Note: The blank in the table indicates that there are controls over this transaction; √ indicates that there is no control over this transaction.

Source: Annual Report on Summary Arrangements and Summary Restrictions in 2013 compiled by the International Monetary Fund

As this point, Marx organically unites the social purpose of improving social production by education with the individual purpose of people's all-round development. Marx's theory of people's all-round development reveals the law of people's all-round development in the unity of human development and social development. Today, the construction of our quality education goal should be built closely around Marx's goal of people's all-round development, so as to achieve the coordinated and unified development of people and society.

III. The characteristics of China's international capital flows

The outbreak of the subprime crisis in 2008 had a huge impact on China's international capital flows. The capital and financial account remained in surplus, but the ratio of capital to GDP fell from a high of 2.7% in the previous year to 0.9%. Since then, the net inflow of international capital attracted by China had rebounded rapidly from 2009 to 2011, partly because of the Federal Reserve's unconventional loose monetary policy and partly because of the recuperative fast growth of China's economy under the influence of various stimulus policies. In 2010, the ratio of China's capital and financial account surplus to GDP hit an historic high of 4.7%. Thereafter, the European debt crisis broke out. In 2013, the Federal Reserve announced its exit from the quantitative loose policy. The domestic leverage ratio was accumulated continuously, the economic growth rate declined by degrees, and the scale of international capital inflows decreased gradually, even turning into the net outflow in 2012. At the end of 2012, the risk of the European debt crisis dropped significantly. Then in 2013, China accelerated the implementation of the RMB internationalization strategy. Taken together, these two factors pushed China's international capital inflows to a record $343 billion in 2013. However, in terms of the trends of the development, the rise in the scale of China's international capital inflows in 2013 was only a singular point. From 2014, China's international capital has seen a net outflow for three consecutive years, of which the outflow in 2015 was as high as $485.6 billion.

Statistics from *World Investment Report 2017* indicate that the total amount of China's foreign investment in 2016 was $183 billion, an increase of 44% compared with that in 2015, which was the first time for China to climb to the second place in the global rankings of foreign investors. In terms of attracting foreign investment, the inflow of China's foreign direct investment (FDI) reached $134 billion in 2016, making it the third largest foreign capital inflow country in the world. After entering 2017, China's global FDI flows fell by more than one third in 2017, the first decline since 2006. In 2017, China's direct investment in North America totaled $30 billion, a decline of 35%. In the same year of 2017, the total amount of China's direct investment in Europe reached $81 billion, an increase of 76% compared with that in 2016. However, China's Chemical Industry's acquisition of Swiss agricultural science and technology companies, which should have been completed in 2016, was postponed until 2017, and the transaction amount of this acquisition reached $43 billion. If this huge transaction had been completed in 2016, China's investment in Europe was only $38 billion, which was still in decline, a decline of 22%. The report pointed out that the main reason for this situation is that the Chinese government increased restrictions on overseas investment to solve the balance of payments problem while mitigating the potential risks of China's financial system caused by fast-growing overseas investment.

Statistics from *World Investment Report 2018* indicate that China remains the largest foreign investment recipient and outward investor in developing countries. In 2017, China attracted the second largest amount of foreign investment in the world, second only to that of the United States. At the same time, China's foreign investment ranked the third place in the world in 2017, after the United States and Japan. However, in 2017, the amount of China's foreign investment also decreased to $125 billion, a decrease of 36%. In addition, China implemented restrictive policies for a large number of capital outflows during 2015-2016, and the foreign investment flows had declined for the first time in 15 years [2].

IV. The risks of cross-border capital flows in China

The enthusiasm and upsurge of the construction and With the increase of uncertainties at home and abroad, the direction of cross-border capital flows in China will be more uncertain and the volatility will be more intense in the future.

A. Imported risk

Despite the differentiation of monetary policies in developed economies, the strengthening of the US dollar is the common result. Emerging economies, including China, will face greater depreciation pressure. The direction and scale of cross-border capital flows will be more uncertain in the future, the difficulty of capital management will increase, the structure of shocks will be more unpredictable, and the possibility of financial crisis will rise sharply. Overall, in the cycle of "dollar strengthening and international capital flows reversal", the risks that need to be addressed include the following aspects: vigilance against the risk of "dollar appreciation → financial crisis in emerging markets". Historically, the liquidity of emerging markets had been impacted at every dollar strengthening stage, leaving countries or regions with weak economic fundamentals vulnerable. The Latin American debt crisis in the 1980s, the Asian financial crisis in 1997, the Russian financial crisis in 1998, the Brazilian financial crisis in 1999, the Argentine financial crisis in 2001 and the emerging European crisis in 2009 all occurred during the period of a stronger dollar. So the risk of "the lag period of the US interest rate hike" should be in vigilance.

There are three common characteristics for the countries or regions in which the financial crisis occurred: (1) long-term imbalance of economic growth, such as long-term reliance on export-driven economy; (2) unreasonable debt structure, such as higher external debt and higher proportion of short-term debt; (3) improper macro-control policies, such as rigid exchange rate systems, improper timing or sequence of capital account opening, insufficient foreign exchange reserves, insufficient financial supervisions, and failure of regulatory coordination mechanisms, etc. It can be seen that the impact of the reversal of international capital when the US dollar is strong is an external cause, and it is a condition that may provoke a financial crisis in emerging markets. However, what really matters is the internal cause, that is, the problem of its own economic development. No matter how powerful the external cause is, it only takes an effective effect by internal cause.

TABLE III. ANALYSIS OF THE REASONS FOR NET OUTFLOWS OF OTHER INVESTMENT ITEMS ON THREE KEY POINTS [3]

	The impact of the financial crisis		The impact of the European debt crisis		The impact of the United States quantitative easing policy exit	
	Native residents	Non-residents	Native residents	Non-residents	Native residents	Non-residents
Currency and deposits	Outflow	Partial return to foreign countries	Outflow	Return to foreign countries	Outflow	Return to foreign countries intensely(since 2015)
Loan	—	Withdrawal loan, return to foreign countries	Withdrawal loan	Withdrawal loan, return to foreign countries	—	Withdrawal loan
Trade credit	—	Withdrawal loan, return to foreign countries	Withdrawal loan	Withdrawal loan, return to foreign countries	Withdrawal loan	Return to foreign countries (since 2015)

B. *Endogenous risk*

China is in a period of systemic risk accumulation, and the manufacturing industry is in a slump. Constrained by the continued weakness of internal and external demand, the drastic volatility of the stock market and the foreign exchange market, the production and operation situation of the manufacturing industry has deteriorated rapidly. At present, China is in a critical period of "three major trends superposition", including economic growth shifts period, structural adjustment pains period, and the digestive period of the previous stimulus policies. Additionally, the asset bubble was brought about by the large-scale capital inflows in the previous period, so China has accumulated a lot of systematic risks. If China's systemic risks are not properly prevented, they may be escalated into systemic crisis. In the future, the international investment environment will change dramatically, and the US dollar will enter the interest rate hike cycle. However, China is in a rate cut cycle, so the Sino-US interest rate differential will further expand, the domestic investment cost will increase, the RMB depreciation expectation will strengthen, and China's cross-border capital, especially short-term cross-border capital flows may be up against an emergency stop or even a reversal, which will have a greater impact on the balance sheets of residents, enterprises and the government, and our country needs to prepare for them in advance.

Cross-border capital management is limited. Similar to most emerging market countries, China's capital account is not fully liberalized, the exchange rate flexibility is not high, and the domestic financial market and foreign exchange market are relatively small in scale, which is not enough to effectively restrain or bear frequent and large-scale flows of the short-term cross-border capital. At the same time, in the management of cross-border capital flows, China adopts the pre-supervision mode focusing on approval, with relatively few macro-prudential management means, mainly relying on quantitative means and administrative intervention. The existing monitoring and early warning are not timely and comprehensive, which impedes the implementation effect of the policy. It is difficult for multi-head supervision mode to meet the needs of current management, there is a lack of coordination between macro policies, and the international cooperation and communication mechanism is also not smooth.

V. THE COUNTERMEASURES AGAINST CAPITAL FLOWS RISK

In the first half of 2016, the proportion of Internet users The supervision of international capital flows should be strengthened. The flow structure is unreasonable and the flow period is uncertain on account of the large scale of international capital flows. Large-scale international capital flows are bound to be accompanied by potential risks, such as exchange rate risk, interest rate risk, price risk and so on. At present, China mainly adopts the administrative rigid management measures in the supervision of international capital, and the measures are actually the embodiment and extension of the administrative management thinking under the planned economy system. Under the condition of open economy, although such measures can achieve a certain effect, they run counter to the trend of international capital free flows. Therefore, in the face of the more complicated international and domestic environment and in the process of economic globalization and integration, it is indispensable to participate in international cooperation, and the regulation way of international capital flows must also shift from rigid management to indirect soft supervision. At the same time, the international capital flow regulation system and index system of the state's financial security should be established and perfected to improve the supervision level and supervision efficiency, and prevent against financial risks effectively.

The supervision of capital market should be strengthened. At present, China's capital market is not very developed, and there are still many outstanding problems need to be solved, such as the supervision of the capital market. In the face of sudden impact of international hot money, it will inevitably be in a muddle, so the capital market will be seriously affected. Therefore, in a more open international economic environment, the construction and supervision of the capital market should be strengthened, a set of mechanisms to prevent financial risks should be established, and the inflows or outflows of speculative capital should be restrained.

The selection and utilization of foreign capital should be appropriate, and the debit and credit should be moderate. At present, China's utilization of foreign capital is increasing, but the utilization efficiency of foreign capital is not rather high. Local governments compete with each other and are fiercely independent, neglecting overall planning and local division of labor, resulting in low-level redundant construction and damaging the utilization efficiency of foreign capital. In the meantime, the entry threshold for foreign investment is lowered and the screening mechanism is weakened in that local governments compete with each other, resulting in the inability to guarantee the quality of a lot of foreign capitals. For developing countries, due to the shortage of capital technology, they have to borrow money and purchase technology. When this trend is accumulated year by year, it will lead to excessive debt. Once the creditor country asks for repayment, it will be unable to repay the loan, resulting in debt crisis. The debt crisis will trigger the decline of investor confidence in the financial market, and the financial market will be sent a tremendous shiver, which will take a serious impact on the country. For this reason, the rational utilization of foreign capital and moderate borrowing and lending are of significance for the development of the economy.

VI. Conclusion

Although China's capital flows have not been fully liberalized, with the continuous expansion of foreign trade and foreign investment, capital flows have become an important factor affecting our country's financial security. The amount of capital flows and the frequency of volatility may trigger China's financial risks, which in turn cause systemic risks. In the process of capital flows, the financial risks of other countries may be transmitted to China, and especially the changes of financial factors in the United States will obviously affect China's financial security, which is an important factor that needs to be paid attention to. The development and change of China's economy and the format of capital management will also influence China's financial security. Therefore, corresponding countermeasures should be formulated for China to cope with different types of financial risks.

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